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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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PROCEDURE. The last few Letters (75, 76) suggested the possibility of a reversal in the secondary trend of the market. But in discussing the signs which may indicate a coming secondary reaction, readers should remember that there is a difference between indications and accomplished fact. A good doctor can examine a patient and conclude that he is seriously ill. Two weeks later the patient may have recovered and be as good as new. This does not imply that the doctor's diagnosis was faulty. It merely points up the fact that in medicine, as in most other fields, there is no such thing as a crystal ball.

Unsuccessful traders are often tempted to blame Dow's Theory for their losses. In most cases, however, an analysis of the situation will demonstrate that these same traders were (1) demanding an infallible system, (2) completely ignorant of the implications of the Theory, (3) acting on their own preconceived notions and wishes, (4) allowing greed or impatience to dictate to their better judgment. After the danger signals appear, the man who sells out is disappointed when a secondary reaction or a bear market fails to materialize. He forgets that he has "insured" himself against the possibility of disaster. By the same token, the man who elected to ignore the danger signals is unhappy when a subsequent reaction wipes out his profits for the year and turns them to losses. He forgets that those "fortunate" traders who did avoid the reaction may have paid the price of insurance on three or four previous occasions before being "lucky" enough to miss the big drop. If Dow's Theory were as perfect as most neophytes desire, there would be few hardships in an investor's life and millionaires would be as plentiful as suburban crabgrass. As it is, however, the Theory is merely the best device we have from which to draw reasonable inferences as to future trends. And unfortunately, the technique of capturing primary swings and avoiding collapses is still an art requiring all the skill, judgment, courage, and control that the average man can muster.

I stated in earlier and recent Letters that I have elected to move increasingly toward the sidelines -- this because of the extended and uncorrected primary swing and because of the recent unsatisfactory action in the price movement. In comparing my results with those of other investors and services, I have (so far) little cause to complain. 1959 has been a difficult year and there has been no sustained upward swing in the market. Even the widely-heralded "summer rally" (which almost every service promised its readers this year) has been more of a fizzle than a rally. In most cases prices are now at or below the levels of early July.

PRICE MOVEMENTS. Because of the hesitant action of the recent market, I feel it important for readers to follow the price movements with extra care. At the last decline lows (point F on chart; industrials 646.53, rails 159.25) volume expanded to 3.05 million shares. Although this was less than the 4.19 million shares which were sold at the earlier D lows, it nevertheless represented higher volume than was seen on any upside day since July. On August 20 a sharp one-day rally (F-G) advanced industrials to 655.02 and rails to 163.98 (the G points). A minor dip to H followed, and then a new rally (H-J) commenced.

On the H-J rally industrials rose 11.19 points, and this advance served to retrace about one-half of the previous C-F industrial decline -- a perfectly normal correction of that decline. Yet on the same H-J rally, rails inched up a meager 1.11 points, and they stubbornly refused to better the preceding minor high point established at G. Volume on the H-J rally was

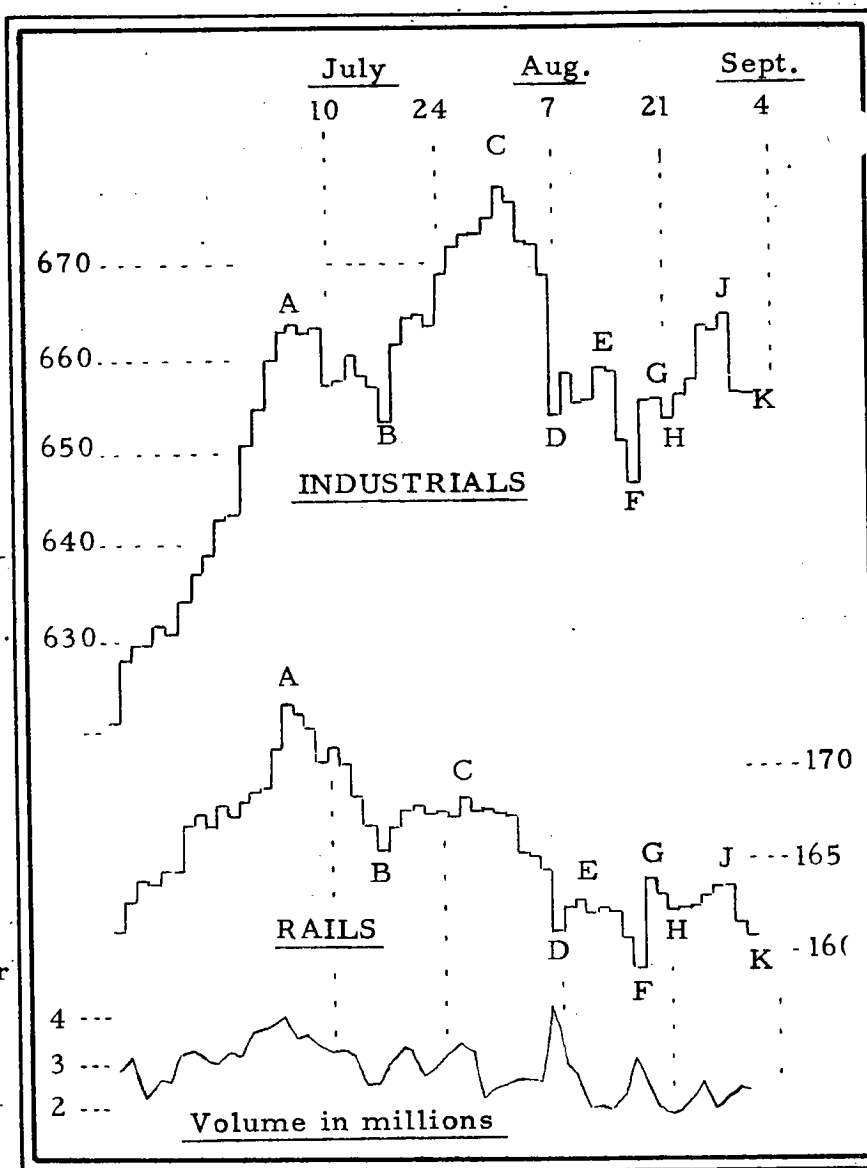
unimpressive, hitting only 2.5 million shares on August 27, the best day of the rally. On August 28 the averages diverged and the market appeared tired. August 31 (Monday) saw industrials edge up again, but here rails declined (divergence again) while volume dropped to 2.16 million shares.

Heavy selling came on September 1, the day the New York banks announced that the prime rate was being raised to 5% (the highest rate in 29 years). Industrials tumbled 8.51 points and rails dropped 1.96 points. In so doing, rails formed a little downward zig-zag (G-H-J-K) -- a pattern which hinted of weakness in the price structure. Both averages dropped fractions on September 2 as volume receded slightly. On the morning of September 3 (this Letter was written Sept. 3, 12 P.M.) the two averages again retreated with volume holding steady and on the low side. The market, this morning, seemed to be suffering from lack of bids rather than selling pressure.

The industrial average is now looking "toppy"; yet appearance alone does not guarantee a primary or secondary top. Rails, meanwhile, have been sliding off in a series of descending minor peaks. The good volume which accompanied the advance to A was not repeated at either C or J which gives the market a tired look. The important low points to consider are industrials at F (646.53) and rails at F (159.25). As long as the two averages can hold above these lows we may merely say that the direction of the secondary trend is in doubt. A bettering of the highs by both averages on increasing volume would provide a bullish classification for the secondary trend. A dual violation of the lows on increasing volume would almost certainly signify that the secondary trend was down. A dual violation on extremely low volume could be deceptive, and in this case we would have to wait for further clarification. It does seem to me that if both averages break the lows on high volume, even long-term investors might take steps to protect themselves against whatever dangers lie ahead.

CONFIRMATION. Throughout the year 1958 I received letter after letter from readers who argued that the rail average was no longer a valid index of shipping and transportation and that consequently, they could not see the need for the two averages' confirming each other. My "rail" mail is markedly thinner now. The reason for this probably lies in the action of the market itself over the last year. Time and again the carriers have confirmed the bullish action of the industrials. And each confirmation has signaled clear sailing ahead.

Recently, on the industrial rally from B to C (see chart) the rails stopped dead and refused even to approach their corresponding high at A. Industrials soon "got the message" and they have not since bettered their C high. In other words, the C-F decline in industrials was tipped off by the weakness in the rail average. It is said that the industrials and more specifically the steel stocks have acted well lately. Nevertheless, I fail to see how the same factors



which can aid the steels and the general market will not also aid the rails. Many observers ascribe the recent rail weakness to the fact that a prolonged steel strike will adversely affect rail shipments, and this is undoubtedly true. Yet if the industrials continue their advance in order to discount a bullish settlement of the steel strike, it seems to me that rails should join in the move. And despite the arguments of those who claim that the rails are "through" as an industry, I would view with suspicion any continued divergence or weakness in the rail average regardless of the brilliance of a solo industrial performance. By the same token, I cannot see how the rails will prosper if the future of manufacturing and production in this nation (as measured by the D-J industrial average) is to be impaired.

QUESTION. What if a bear signal were to be given in the period ahead, and this bear signal came prior to the high volume and the rail confirmation (a rail bettering of the 181.23 high of 1956) which you have so often mentioned?

ANSWER. Following a full scale secondary if both averages approached but refused to better their previous highs (industrials 678.10, rails 173.56) and the two averages then turned down and violated their secondary reaction lows on increased volume I would then consider that the primary trend had turned from bull to bear.

During the 1932-37 bull market the rails, having hit a high in 1933, did not better that high until late 1936. Industrials had been working to new bull market highs during that whole 1933-36 period. In late 1936 Robert Rhea was asked whether he would have taken a bear signal as a valid primary reversal signal if that reversal signal had come without a rail bettering of the 1933 high. Rhea's answer was that since the market was then in its third or last phase, he would have taken any bear signal as proof that the bull market had ended, regardless of whether the rails had confirmed (by bettering their 1933 high) or not. It seems to me that the same situation applies today.

SQUEEZE. In June of this year I discussed the interest rate and bond cycles, and I noted that these cycles tend to move in extended swings of about thirty years. From 1920 to 1946 the long-term trend was to lower interest rates. Since bonds fluctuate with the interest rates, this produced a bull market in bonds. From 1946 through the present, however, the long-term trend of interest rates has been up, and we have been watching a great bear market in bonds. For this reason I have not suggested the purchase of bonds in any of these Letters.

The money market is now tightening up like a drum. Despite the steel strike, which should have temporarily eased demand, the need for money is becoming more acute each day. For instance, consumer installment credit increased 500 million dollars in July, the biggest jump in four years. Municipalities, cities, and states, which usually hold off in a tight money market, are continuing to come in with urgent new bond issues.

At present the U.S. Government finds itself in the position of having to refinance over one-third the national debt or 85 billion dollars during the next year -- a year that is already finding money tighter than at any time since 1930. To make matters even more difficult, Congress has recently refused to raise the 4 1/4% legal interest ceiling on Treasury bonds. I might explain that Treasury bonds mature in five years or more, and they may not pay above 4 1/4% interest. Treasury notes, on the other hand, mature in under five years and are not restricted as to interest rates.

Since the Treasury cannot sell low-yielding 4 1/4% bonds in the present tight market, it must now compete in the short-term money market with its high-yielding notes. The Treasury normally sells long-term bonds to institutions who salt them away in the vaults. But the Treasury's new customers are the commercial banks and the big investors. These fellows find the notes irresistible because of (1) high-yield, (2) no-risk, (3) short-term maturity. Moreover, the banks may use Treasury notes as reserves against which they can make new loans. Economists throughout the country have labeled this latter turn of events

"highly inflationary". Yet few people grasp the hidden facets of the Treasury's wholesale entrance into the short-term money market -- while the pressure is driving up short-term interest rates, it has (1) set off a vicious battle for new funds in the money market, (2) begun to attract money that is now in the stock market.

There is a third aspect of the fast-changing money picture. I mentioned last week that the savings banks and savings & loan associations might begin to see large chunks of money leaving their premises for new and higher debt instruments such as Treasury notes. I also wrote in Letter 76 that new deposits had already been slowing down at the savings banks. Last week, however, it was announced that during July deposits did worse than slow down in the nation's 519 mutual savings banks -- in July the savings banks actually lost 54 million dollars against a gain of 88 million in July, 1958. When it is remembered that the savings banks are huge mortgage financiers, this turn of events can hardly be called conducive to a continued housing boom.

Most people, and this includes the men in the Government, do not easily accept or understand new ways of thinking, but the price of money (interest rates) in the coming months may well surprise even the most open-minded investors. This nation has never seen a boom as large as this one come within a cycle of steadily increasing interest rates. For this reason, I believe that we must cast aside all dogmatic opinions about what should and must happen in the period ahead. It is obvious that the averages are looking beyond the "inflation" talk and the steel settlement. They are examining the evidence with an emotionless accuracy and knowledge which is beyond the ability of the most informed economist or the most learned board of directors.

STOCKS. About half the stocks on the board look weak; so many, in fact, that I would have to write a whole Letter just to indicate important support points which are being approached or broken. But here are a few interesting numbers -- I would sell Bethlehem Steel on a close of 52 or below, U.S. Steel on a close of 97 or below, G.E. on a close of 76 or below, Westinghouse on a close below 87 1/2, American Can on a close below 43, Olin Mathieson on a close below 47 1/2, Monsanto on close below 47 1/2, Heyden Newport on close below 19, Dow Chemical on close of 80 or below. I would kick out any stocks in the building or construction trades; aircraft and airlines seem to have had it, and the rubbers are also breaking their supports. If one is inclined to the short side, I would recommend General Tire if it closes at 62 or below. This stock has a tremendous top formation, and 62 would violate a base of many months.

In answer to many questions regarding individual stock charts, I use the daily stock charts with volume put out by Traders Research, Inc., Suite 375 - Arcade Building, St. Louis 1, Missouri. The standard textbook which may be used in charting individual stocks is "Technical Analysis of Stock Trends" by John Magee. As far as I am concerned, individual stock charting is an amplification of original Dow Theory technical methods. Although far from perfect, I find it a great help particularly when used with Dow Theory conclusions as to the trend of the market.

(Written - Sept 3rd at noon)

<u>INDUSTRIALS</u>		<u>RAILS</u>	
Highs---	(pt. C) 678.10	(pt. A) 173.56	
Lows---	(pt. F) 646.53	(pt. F) 159.25	